Supreme Court, U. S.
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IN THE

Supreme Court of the United States

OCTOBER TERM, 1978

No. 78-1665

JERSEY CENTRAL POWER & LIGHT COMPANY,
Petitioner

v.

FEDERAL ENERGY REGULATORY COMMISSION, *et al.*
Respondents

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Third Circuit

PETITIONER'S REPLY MEMORANDUM

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PETITIONER'S REPLY MEMORANDUM

In its Petition, Jersey Central Power & Light Company ("Jersey Central") sought to place before this Court a clear-cut legal issue, namely: whether, by reason of previous decisions of this Court, the Federal Energy Regulatory Commission ("FERC" or "Commission") lacks authority to approve an electric utility rate whenever part of the justification for the rate consists of cash expenditures made but not "accrued" as "expenses" during the period prior to the rate's effective date. Neither of the briefs in opposition address this issue. Instead both FERC

and Allegheny Electric Cooperative, Inc. ("Allegheny") contend that the result reached below is correct (FERC Brief in Opp., pp. 10-13; Allegheny Brief in Opp., pp. 7-13) and that the conflict among the United States Circuit Courts of Appeals with regard to the treatment of fuel adjustment clauses is too insignificant to warrant Supreme Court review (FERC Brief in Opp., pp. 13-14; Allegheny Brief in Opp., pp. 13-16).[1] Neither of these arguments undermines the considerations set forth in Jersey Central's petition.

Both respondents urge that the Commission and the United States Court of Appeals for the Third Circuit correctly construed Jersey Central's prior (1973) fuel adjustment clause. But Jersey Central's petition did not challenge that construction. Assuming, *arguendo*, that the Commission correctly construed the *1973 clause*, the question still remains as to whether that construction supports the conclusion that the Commission lacks authority, by reason of the general rule against retroactive ratemaking, to consider the justness and reasonableness of the phase-in component of the *1976 clause*.

The Commission held that it lacked such authority. The court below did not address the issue directly, stating only that "it appear[ed] . . . that the Commission [was] on solid ground in concluding that a reasonable interpretation of the [1973 fuel adjustment clause] compel[led] the result it reached." (Petition, p. 8a). The court rejected Jersey Central's request for a ruling on this issue. *Compare Jersey Central Power & Light Co. v. FERC*, No. 78-1185 (3d Cir., Feb. 2, 1979), *denying rehearing* 589 F.2d 142 (1978) (Petition, p. 10a), *with* Petition for Rehearing, *Jersey Central Power & Light Co. v. FERC, supra* (Petition, pp. 37a-42a).

[1] Although the Boroughs of Madison, Butler, Lavallette, and Seaside Heights, New Jersey, intervened below, they did not respond to the petition for certiorari.

Neither of the respondents provides a rationale for the conclusion that the appropriate effect of the construction of the 1973 fuel clause is the rejection of the phase-in component of Jersey Central's 1976 fuel adjustment clause. Much of their briefs is devoted to the reiteration of arguments suggesting the rate set may be unjust and unreasonable.[2] The Commission did not rule on these arguments. As a consequence, the only potential basis for the rejection of the phase-in provision is the general rule against retroactive ratemaking. While FERC asserts that the decision below necessarily rested on this rule (FERC Brief in Opp., p. 11) and Allegheny claims that the United States Court of Appeals for the Third Circuit "... merely appl[ied] the rule...in its most simple form...." (Allegheny Brief in Opp., p. 9), neither the third circuit nor the Commission articulated a basis for applying the rule to Jersey Central's 1976 tariff. In view of this, the result

[2] Allegheny theorizes that Jersey Central's characterization of the phase-in component of its 1976 fuel adjustment clause as just and reasonable lacks evidentiary support in the record. (Allegheny Brief in Opp., p. 6). However, since the Commission denied Jersey Central an opportunity to present evidence on this point at a hearing, Order Granting Motion for Summary Disposition in Jersey Central Power & Light Co., Docket No. ER 76-813 (Oct. 25, 1977) (Petition, p. 25a), the rate set under that clause must be assumed to be just and reasonable at this juncture. *Cf. Jersey Central Power & Light Co. v. FERC*, 589 F.2d at 146.

Similarly, Allegheny states incorrectly that the Commission rejected as unjust and unreasonable the fuel adjustment surcharge provision considered in Opinion No. 790, Public Service Co. of New Hampshire, 19 P.U.R. 4th 210 (FPC 1977), *rehearing denied*, Opinion No. 790-A, Docket No. ER76-285 (May 20, 1977), *aff'd* No. 77-1592 (D.C. Cir., filed May 3, 1979), *petition for cert. filed by Public Service Co. of New Hampshire* (Aug. 1, 1979) (No. 79-169). (Allegheny Brief in Opp., p. 5). *See* Opinion No. 790, *supra* at 217-20.

below cannot be assumed correct.[3] *See Borough of Ellwood City v. FERC*, 583 F.2d 642, 649 (3d Cir. 1978) (application of filed rate doctrine proper only when purposes of Federal Power Act furthered); *accord, Sunray Mid-Continent Oil Co. v. FPC*, 364 U.S. 137, 147 (1960).

The Commission recognizes that there is not only a conflict between the circuits with respect to the issue here involved (FERC Brief in Opp., p. 12), but also that two state supreme courts have reached conflicting results on the same issue (FERC Brief in Opp., p. 14 at n.14).

The respondents' suggestion that this case nevertheless lacks the level of significance necessary to justify consideration by this Court cannot bear scrutiny. First, despite FERC's assertion to the contrary (FERC Brief in Opp., p. 13-14), the electric utilities' increased sophistication regarding fuel adjustment clause design does not remove the obstacle mistakenly erected by the Commission which prevents full recovery of fuel costs by utilities, such as Jersey Central, whose clauses still contain lag provisions.[4] More significantly, the effect of the decision below cannot, as the Commission implies (FERC Brief in Opp., p. 13-14), be confined to the narrow context of cases involving transitions between different fuel adjustment clauses. Respondents suggest no logical means for confining the Commission's interpretation of the rule against

[3] Allegheny's assertion that both the third circuit and the Commission found that the expenditures at issue were not properly allocated to the period occurring after the 1976 tariff's effective date (Allegheny Brief in Opp., p. 7) is misleading. The decisions below found that those costs were incurred during the efficacy of the 1973 tariff. Jersey Central agrees, but that finding encompasses only the timing of the cash outlays and not the timing of the recognition of those outlays as "expenses" on its books.

[4] While the record contains no information regarding the extent to which lag provisions persist throughout the industry, Allegheny states that lag provisions are common. (Allegheny Brief in Opp., p. 3).

retroactive ratemaking to the fuel adjustment clause context. (Allegheny Brief in Opp., p. 11). Since cash expenditures made in one period but recognized for ratemaking purposes as costs incurred in another period are common in the utility industry, the petition raises significant issues justifying the grant of certiorari.

The recent decision of the United States Court of Appeals for the District of Columbia Circuit in *Public Service of New Hampshire v. FERC*, No. 77-1592 (D.C. Cir., filed May 3, 1979), *rehearing denied* (July 3, 1979), *petition for cert. filed by Public Service Co. of New Hampshire* (Aug. 1, 1979) (No. 79-169), does not resolve those issues. Neither the D.C. Circuit's opinion nor its order denying rehearing dealt with the questions raised in Jersey Central's petition, even though they were before the court.[5] As a result, that case does not obviate the need for Supreme Court review.

Respectfully submitted,

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[5] Two of the parties before the D.C. Circuit, Pennsylvania Electric Company and Metropolitan Edison Company took a position virtually identical to that urged by Jersey Central. *See* Petition of Pennsylvania Electric and Metropolitan Edison Co. for Rehearing, *Public Service of New Hampshire v. FERC, supra* (D.C. Cir., filed May 17, 1979) (App. A, pp. 2a-8a, *infra*).

APPENDICES

United States Court of Appeals

FOR THE DISTRICT OF COLUMBIA CIRCUIT

No. 78-1329 September Term, 1978

PENNSYLVANIA ELECTRIC COMPANY,
Petitioner

v.

FEDERAL ENERGY REGULATORY COMMISSION,
Respondent

ALLEGHENY ELECTRIC COOPERATIVE, INC.,
Intervenor

And Consolidated Case No. 78-1330

BEFORE: Tamm and MacKinnon, Circuit Judges; and Pratt*, District Judge, United States District for the District of Columbia

ORDER

Upon consideration of petitioners' (Pennsylvania Electric Company and Metropolitan Edison Company) petition for rehearing, it is

ORDERED, by the Court, that petitioners' aforesaid petition for rehearing is denied.

Per Curiam

FOR THE COURT:

GEORGE A. FISHER
Clerk

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* Sitting by designation pursuant to Title 28 U.S.C. § 292(a).

United States Court of Appeals

FOR THE DISTRICT OF COLUMBIA CIRCUIT

PENNSYLVANIA ELECTRIC COMPANY
Petitioner,

METROPOLITAN EDISON COMPANY
Petitioner,

v.

FEDERAL ENERGY REGULATORY COMMISSION
Respondent,

Docket Nos.
78-1329
78-1330

PETITION OF PENNSYLVANIA ELECTRIC COMPANY AND METROPOLITAN EDISON COMPANY FOR REHEARING

I. INTRODUCTION

Pennsylvania Electric Company and Metropolitan Edison Company (Petitioners) hereby apply for rehearing of this Court's judgment in the above captioned proceeding entered on May 3, 1979. In its opinion, this Court agreed with the Federal Energy Regulatory Commission's interpretation of the nature of Petitioners' superceded fuel clauses. Petitioners accept that conclusion *arguendo*. Petitioners dispute, however, that this interpretation of

their tariffs necessarily compels the conclusion that the proposed surcharges constitute proscribed retroactive ratemaking.

II. ARGUMENT

These Petitioners did not rely primarily on the argument that their superceded fuel clauses were "cost of service" in nature and hence merely deferred billing. Rather Petitioners' primary contention (see Argument A to Petitioners initial brief) was that, regardless of the nature of their prior fuel clauses:

> "[t]he surcharges are simply not an attempt to recover 'costs' which were incurred during the effective period of the old fuel clauses and which the old fuel clauses should have recovered. Rather, the surcharges seek to recover fuel costs properly allocable to the current period. As such, they do not violate the rule against retroactive ratemaking." (Petitioners reply brief, p. 7).

The Court's opinion simply fails to treat Petitioners' main argument.

Petitioners will not belabor their argument here. In essence, the argument is that in many instances the recognition of "expenses" for both accounting and ratemaking purposes does not coincide with the time of the cash expenditures related to those "expenses."

In view of the Court's analysis, we believe that a detailed example may serve to illustrate our argument. Suppose, for example, that Utility A normally incurs maintenance expenses of approximately $1,000 per year. Utility A's filed rate is based upon recovery of approximately $1,000 for maintenance expenses.[1] In the Court's

[1] Recovery of such expenses, of course, is on a per unit of sales basis.

terms, Utility A's rate is a "fixed rate" tariff which does not guarantee that there will be dollar-for-dollar recovery. Let us suppose further that during 1977 there is an unusual occurrence (e.g., a hurricane) and Utility A experiences an extraordinary maintenance expense level of approximately $10,000 in 1977.

Under proper accounting methods, Utility A is required to amortize this extraordinary maintenance expense over the next ten years. Hence, in 1978, Utility A reflects on its books a maintenance expense of $1,000 and an additional "amortization expense" of $1,000. Utility A is entitled to seek by any rate increase it files for over the next several years to recover under its rates both its annual $1,000 in normal maintenance expense and its annual $1,000 in "amortization expense." And this is so even though this "amortization expense" represents dollars actually spent in 1977. It has never been argued that Utility A's rates set in 1978 or 1979 or later would constitute retroactive ratemaking merely because they would include an element which recovers for an amortization expense properly reflected on its books and allocable to the current period.

Expenses which represent the amortization of prior cash outlays are quite common (e.g. depreciation expense, extraordinary property losses, deferred maintenance, etc.). The essence of the concept is that "expenses" arise and are recorded on books of account, not at the time of cash outlay, but at some other time—the time of recognition to be based on sound accounting principles. It is a basic principle of accounting to effect, as nearly as possible, a matching of revenues and associated expenses. This principle supports the deferred fuel expense accounting which Petitioners have utilized since the inception of their prior fuel clause.

Accrual accounting concepts are particularly applicable to fuel expense accounting. Even absent deferred fuel expense accounting, the amount of fuel "expense" for any given month is nothing more than a book accounting entry. This book entry has no direct relationship to the amount of cash which a company spends in a given month to purchase fuel. Cash is spent to purchase fuel which goes into inventory. Both the dollars spent and the amount of fuel purchased in a given month may differ significantly from the amounts and the dollars of fuel consumed in a given month. Nuclear fuel expense accounting presents a good example of the process. The cash outlay for nuclear fuel rods may occur several months or even years in advance of the accrual on the books of each monthly nuclear "fuel expense." The Commission's regulations even require that when an estimate of useful life of fuel rods changes, the monthly "nuclear fuel expense" amount accrued on the books must also change to reflect the revised estimate (See 18 C.F.R. Part 101, Uniform System of Accounts, Account 518). When a company records on its books a nuclear fuel expense of $1,000 for a given month, a process by which it "amortizes" a portion of a *prior* cash outlay, it cannot constitute retroactive ratemaking for the company to seek to recover under its current fuel cost adjustment clause, $1,000 in nuclear fuel "expense."

In short, companies are entitled to design rates to recover all "expenses" which, under appropriate accounting principles, are properly recognized as accruing during the current period of the rate in question. This Court defines retroactive ratemaking as a "... rate designed to recoup past losses." (Slip Op. at 28). We agree. But "losses" do not and cannot arise until they are recognized by the accounting process. The dollars these Petitioners seek to recover were not, and never had been recognized as "losses" or "expenses" in any period prior to the effective period of the rate in question.

Although the Court does not deal with the accounting examples or the argument offered by Petitioners, it comes close to treating the subject when it attempts to distinguish PGA and RD&D clauses:

> "The difference between PGA and RD&D clauses on the one hand, and the proposed surcharges on the other, is that the former prospectively provided for after the fact maturing, whereas imposition of the latter (the surcharge) would be a retroactive shift from a 'fixed rate' to a 'cost of service' tariff." (Slip Op. at 34, n. 67).

As already noted, Petitioners argument does not depend upon the nature of the prior tariff (i.e., whether it is "fixed rate" or "cost of service"). The PGA regulations provide for the establishment of a separate account to track the results actually produced by the clause and for subsequent adjustments based on these actually recovered amounts (18 C.F.R. §154.38). Therefore, Petitioners will accept *arguendo* the Court's distinction of PGA clauses.

The Court's conclusion with respect to the nature of RD&D clauses, however, is in error. In the first place, a close reading of the Commission's regulations reveals that the clauses themselves are not, in the Court's terms, cost of service clauses. The mechanics of the clause required by the RD&D regulations precludes *precise* (i.e., "cost of service") after the fact matching.[2] More importantly,

[2] Several features require this conclusion: 1) a change cannot be effected unless there is a specified minimal impact ($.0001 per KWH); 2) the unit rate change must be designed upon sales for the 12-month period ending 3 months before the proposed effective date and applied to future sales, *with no requirement of an accounting for amounts actually recovered thereby, or any recognition of amounts actually recovered in the design of the next clause;* and finally 3) the clause cannot be used to effect a rate reduction below the level of RD&D expenditures existing before the institution of an RD&D clause (See 18 C.F.R. §35.22).

however, the regulations specifically address the subject of how the *initial* RD&D clause is to be effected. *No prospective filing is called for.* The utility is clearly entitled to file its first RD&D clause and recover its RD&D expenditures for the 12-month period ending 3 months *before* the proposed effective date. The only requirement is that the clause be filed 60 days prior to its proposed effective date (18 C.F.R. §35.22). Hence, at least with respect to the initial RD&D clause, there is absolutely no prospective provision for the after the fact revenue recovery which takes place under that first RD&D clause. In short, RD&D clauses simply cannot be distinguished from the situation presented here. If one were to substitute "fuel cost expenses" for RD&D expenses, the impact of the Commission's present RD&D regulations would be to authorize precisely that which Petitioners are requesting here.

In sum, the retroactive ratemaking concept is, as the Court described, applicable to an attempt to recoup past "losses" by a retroactive rate increase. Past "losses" do not and cannot exist until they are recognized by application of proper accounting principles. The retroactive ratemaking concept simply does not bar recovery of proper amortization expenses, depreciation expenses, deferred maintenance expenses, fuel expenses, or any other expenses which, under proper accounting principles, are recognized as accruing during the effective period of the rate in question. The Commission has extended the retroactive ratemaking concept to an area it was never meant to cover. In doing so, it abrogates its responsibility under the Federal Power and Natural Gas Acts to determine the justness and reasonableness of Petitioners' filed rates. The Commission should be required, on remand, to address the question of whether the surcharges are just and reasonable.

III. CONCLUSION

Wherefore the instant petition for rehearing should be granted and the proceeding should be remanded to the Federal Energy Regulatory Commission for a determination of the justness and reasonableness of Petitioners' proposed surcharges.

Respectfully submitted,

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May 17, 1979